A COMPREHENSIVE GUIDE TO

Budgeting

FOR HEALTH CARE MANAGERS

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Cover Image (Title Page, Part Opener, Chapter Opener): © 10255185_880/iStock/Getty
Printing and Binding: Edwards Brothers Malloy
Cover Printing: Edwards Brothers Malloy

Library of Congress Cataloging-in-Publication Data
Names: Ross, Thomas K., author.
Title: A comprehensive guide to budgeting for health care managers / Thomas. K. Ross.
Description: First edition. | Burlington, Massachusetts: Jones & Bartlett Learning, [2019] | Includes bibliographical references and index.
Identifiers: LCCN 2017038329 | ISBN 9781284143546 (pbk.: alk. paper)
Subjects: | MESH: Health Services Administration—economics | Budgets
Classification: LCC RA971.3 | NLM W 84.1 | DDC 362.1068/1—dc23
LC record available at https://lccn.loc.gov/2017038329

6048

Printed in the United States of America
22 21 20 19 18   10 9 8 7 6 5 4 3 2 1

This book is dedicated to my family; past, current, and future students; teachers; and colleagues without whom this book would have never been conceived, let alone completed. I am grateful to the staff of Jones & Bartlett Learning—Michael Brown, Danielle Bessette, Juna Abrams, Robert Boder, and Shannon Sheehan—and to the reviewers for their comments and efforts. The debt I owe all of you can neither be calculated nor be repaid; thank you all. All errors are solely the responsibility of the author.

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Contents

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Thomas K. Ross is a member of the faculty at Appalachian State University, Boone, NC, USA, in the Department of Nutrition and Healthcare Management, where he teaches courses in healthcare finance and healthcare budgeting. He received his PhD in economics from St. Louis University, and an MBA in finance and accounting and a BBA in accounting and management from the University of Cincinnati. His first book, *Health Care Quality Management: Tools and Applications*, was published in 2014, and he is working on a text on applying Lean Six Sigma in health care. He previously taught at East Carolina University, King's College (PA), and Indiana University South Bend. Dr. Ross has worked in hospitals as director of patient accounts and financial analyst, and in healthcare information technology companies supporting budgeting and cost reimbursement systems.


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Preface

The principal problem with financial education is that finance does not prepare students for the work they need to perform in their professional and personal lives. Universities do a questionable job of preparing students to select a profession, make major purchases, or file their income taxes. The burden of debt, $90,336 per household, as well as student loans, $48,172 for households with this type of debt, are often-discussed issues, but little guidance is provided to be cautious in acquiring debt or minimizing the cost of debt (Frankel, 2016). On the other hand, it often seems that financial aid offices and federal policies encourage reckless use of debt. The $20 trillion of national debt provides yet another example of irresponsible debt use for citizens. A 1.0% increase in interest rates will translate into an additional $200 billion annual outflow of funds, reducing what can be spent on health care, education, defense, highways, or any other government-provided good or service.

Corporate finance likewise fails to prepare current and future managers for the primary financial tasks they are called upon to perform. Multiple chapters in other finance books are devoted to understanding the capital structure, setting prices, allocating overhead, and securing working capital but operating managers rarely need this information. Managers will need to work with budgets on a monthly, if not daily, basis and budgeting is not a topic that finance books devote significant attention to. The primary goal of this text is to rectify this situation by demonstrating how to construct and interpret budgets and highlighting the cost of using resources. The first goal is to remedy a problem I find in most books and articles on budgeting; that is, their inability to impart the "why it should be done," "what can be done," and "how to do it" to the reader. U.S. universities seem to relish in providing courses such as "Fairy Tales," "The Philosophy of Harry Potter," and "Witchcraft in the 16th Century." This author values competency-based education—teaching learners concrete skills that will be applied, rather than abstract and/or outdated ideas. Readers should feel comfortable that when called upon, they will be able to construct a budget required to accomplish a task. Similarly, at the end of a budget period, they will be capable of analyzing performance: why were more or less resources consumed than budgeted?

Even if you are never called upon to produce a budget, you will live and work under a budget, so you should be able to contribute to budget discussions by asking fundamental questions: what is the goal, what methods or alternatives are available to achieve this goal, and which path should be taken? What production method produces the best result, which method can be performed at the lowest cost, and which should be selected if there is a trade-off between the best outcome and the lowest cost? A naive approach—the best outcome and damn the cost—is not acceptable. Decisions must be made recognizing the alternatives foregone. Is the best result worth giving up other things, or are we willing to accept less than the best to enjoy other goods and services? Understanding the larger picture is the second goal: how our choices affect every part of our lives, the lives of those around us, and the lives of people we do not even know.

My students were uncomfortable with textbook discussions of budgeting that lacked detail and failed to impart essential budget skills. Finance texts devote a large amount of time to who, what, and when, and less time to how and why: who must send the budget to whom, who approves the budget, what procedures are followed, what are budget timetables, etc. Books contained procedural minutiae, and rather than building an understanding of budgeting goals, they covered dry facts and procedures and ignored ideas. As Confucius noted, "I'm told and I forget. I see and I remember. I do and I understand." The traditional approach to budgeting leads to forgetting.

To understand the how and why, my students prepare budgets using different methodologies and evaluate how the different systems and assumptions affect resource estimates. In budgeting, it is essential to understand goals and see the entire process in action, whether you are the CEO or CFO responsible for overall organizational performance or an operating manager running a single department. Budget building often entails simply increasing the amounts previously expended by a department or organization for expected future work—little insight is gained from this exercise. Budgeting should highlight how departments and organizations operate: how goods and services are produced and the resources required to produce output. Seeing the interrelationships between the desired end, the committed resources, and their cost is the essence of budgeting, expands one's understanding of operations, and is the foundation to make organizations more effective and efficient.

The primary question is whether the organization is doing the best it can. Are employees maximizing the value of the organization? Secondary questions include whether we want to produce this output, in this quantity, with these resources, in these quantities, at these prices. The budget should guarantee that value is maximized, but the pertinent question is *value in whose eyes?* In for-profit organizations, shareholders want maximum profits, employees want higher salaries, and consumers want high-quality and low-price goods. Budgeting is a means to recognize and balance competing interests. Managers should understand the roles of their departments or divisions vis-à-vis the organization, the role of the budget vis-à-vis the organization's operation and mission, and the relationships between stakeholders. Budgets are *information systems*, and goals and resource allocations define an organization's priorities and plans.

This book is not a bureaucratic exercise to show readers how to fill in budget forms. Readers should be as comfortable scratching out a budget on the back on an envelope as they are creating a budget in Microsoft Excel. It is more important to accurately estimate resource requirements on an envelope than to have a spectacular slide presentation with tables and charts that misstate resource needs. The quality of information is the most important attribute, not its presentation. The primary objective of budgeting is to understand the relationship between inputs, outputs, and outcomes, and financial training should impart the skills necessary so that managers can accurately estimate the cost of running an operation. The budget presentation is secondary; a monkey in a silk suit reading presentation slides is still a monkey.

Budget procedures per se—who sits on the budget committee, when budgets must be submitted, who reviews and approves the budget, etc.—are briefly discussed. Managers will find these issues dictated within the confines of their particular organizations, and they will have to deal with the specified guidelines and employees. The procedures established within an organization are more important than any set of general guidelines that could be provided, so little time is spent on these issues.

This text introduces the reader to the logic of budgeting and the types of budgets. When properly constructed, budgets are systems of cause and effect. Resources, labor, supplies, machinery, and buildings are purchased to produce a result. Managers should understand why expenditures are made, what higher budget allocations add to output, and whether the expenditures increase the value of the organization.

Budgeting tools are introduced and connected to their practical uses and theoretical foundations. The first question that should be answered before undertaking budgeting is why the organization exists. An organization's survival may depend upon its employees' understanding of "the big picture" and their ability to build and analyze budgets that advance organizational goals. To impart these skills, budgeting structures and relationships are presented in forms, flowcharts, examples, and tree structures. The multifaceted presentation is designed to impart an organic understanding of what is taking place, what questions are being asked, why it is occurring, and how the questions are answered.

The primary budget question is, how much will it cost to conduct activities and produce results in the following year? The typical response is what it cost last year with an increase to accommodate rising resource prices. This answer is unfortunate and all too common; it assumes what the organization did last year is worth continuing and there is no reason to delve deeper and evaluate performance—life on automatic pilot. Economists assume individuals are always comparing the benefits and costs of their actions and changing their behavior when opportunities arise to increase their satisfaction. Budgets should be the vehicle to produce this same dynamic within organizations.

A budget is a simplified model of a system constructed to achieve a purpose—it describes a production process in dollars and cents. A budget specifies what is to be accomplished, the resources planned to be consumed in achieving this end, and the expected cost of those resources. The power of budgeting comes from this simplified understanding of reality; it provides a lever on the world, where one can ask and evaluate the question, is a change likely to produce a better outcome? Will different inputs or production methods produce a better or lower-priced good or service, lower the quantity or cost of resources consumed, and/or increase consumer satisfaction?

A second departure from traditional approaches to budgeting is the emphasis on economics. The optimal budget provides just enough resources to accomplish the tasks set forth. A tight or efficient budget is the ultimate goal. More resources should not be expended to produce a good or service, because it is wasteful. People are better off when goods and services are produced efficiently and resources are allocated to their best uses. Reaching efficiency, however, creates winners and losers; lower-cost outputs benefit consumers, but employees required to increase their productivity may believe themselves to be worse off.

Adam Smith noted that one of the wondrous elements of market systems is that when people work to obtain the greatest benefits for themselves, they often produce the greatest benefit for everyone else. Striving for higher profits and incomes leads people to produce better products and lower costs to overcome their competitors, and these efforts benefit consumers. Markets work automatically; an inability to produce goods consumers want at prices they are willing to pay generally results in business failure. Competition for resources takes resources away from inefficient or ineffective organizations and reallocates them to uses where they produce higher value.

Resource allocation decisions within organizations are not automatic. Budgets should fulfill the same role in organizations as markets perform between producers and consumers. Budgets should identify and encourage value-adding activities and reduce low-value activities. The ultimate goal is maximizing effectiveness and efficiency; however, the reader will see that incentives matter and managers frequently strive to maximize the size of their budgets. Budget maximization is seldom compatible with producing the best product at the lowest price. Readers will become familiar with strategies to maximize a budget and mechanisms to prevent inappropriate, excessive use of resources.

One of my biggest regrets as an economist is that economics is often seen as irrelevant. Basic and uncontroversial ideas about the role of prices and markets are often lost in the minutiae and controversy of macroeconomic intervention and government policies. My students report economic concepts are infrequently used in their classes. This book synthesizes the practical topic of budgeting with economic concepts. None of the concepts will be out of the reach of a reader who has yet to take an economics course, but if the reader has never taken a class in economics, I hope he or she might be encouraged to seek further economics training. For readers who have taken prior economics courses, I hope they gain a greater appreciation of the information they learned and see how economic ideas pervade all aspects of life.

Economics is the foundation of finance, and the goal of financial management is to ensure an organization has sufficient resources to carry on operations indefinitely. Cash inflows must equal or exceed cash outflows, and the primary mechanism to reach this result is creating a budget that balances revenue and expenses and operating according to the budget. The text provides you with the two critical finance skills that all managers should master: constructing a budget and evaluating budget variances.

You may think that budgeting is more important in your professional lives since many of us are paid to prepare and execute organizational plans, but intelligently allocating scarce resources is probably more important in our personal lives. In our private lives, we control *all* major decisions: how much we earn and spend; in our professional lives, we may be told what to do and how to do it. Budgeting is the same for everyone: what do we want, what do we have to spend, and what should we buy? To paraphrase one of Charles Dickens's characters: the difference between hell and heaven is spending one dollar more or less than we earn; having a plan of what we earn and what we spend is the first step toward heaven.

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